# WORKING PAPER

**BASIC ECONOMICS**
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**July 2005**

EPI Working Paper No. 272

**Economic Policy Institute**

# BASIC ECONOMICS

## The FCC should set a 30% Limit on Cable TV Market Shares

***By William G. Shepherd***

The Federal Communications Commission needs to set a 30% limit on market shares in the national cable TV market. That 30 % cap is based on sound economic analysis and is the best protection against the harms that more mergers or corporate tactics could impose if their market share is increased into the 30 to 40% range or even higher. Those economic and social harms would be large.

In fact, monopoly power has already been raising prices and profits to monopoly levels for three decades and their market power is increasing as market shares of the largest firms approach the 30% threshold. And the higher market shares that would result from raising the cap would have no valid economic justifications. Furthermore, the growing market share of direct broadcast satellite service is having no discernable effect on the Cable industry's pricing power. Hence, the FCC should treat cable TV as a separate market from other multichannel video programming distributors (MVPD) such as satellite TV. If the FCC can't reduce the market power of the largest cable TV firms, it should at least try to prevent the concentration of more of it.

## Economic Analysis of the Actual Conditions

The cable TV industry's structure and pricing methods have changed little in recent years. That's true, regardless of the frequent talk about big changes that may be occurring in the telecommunications sector.

**Local-monopoly markets.** The cable TV industry has two major sets of markets, which are tightly related and reinforcing. First, there's the *local-monopoly level of markets*, where cable TV firms hold thousands of actual or nearly-complete monopolies. Such cable TV monopolies are found in just about every important city and locale in the country, from Portland, Maine to San Diego, California and across middle America. The local monopolies aren't much restrained by competition or by potential competition, or by any other factors like consumer demand or new technology (such as satellite services or the Internet) (U.S. General Accounting Office 2000).

**National market.** Second, there's also the all-important *national market level*, which contains the one whole national U.S. market. This is a real and relevant economic market, both for understanding competition and for defining any monopoly power and measuring its effects. The national market is the true zone of strategies and competitive interactions among the cable TV companies. It's where the leading cable firms like Comcast and Time Warner do whatever competitive tactics they do.

**Tight oligopoly and shared monopoly.** Because this national market is highly concentrated, the competition tends to be soft and limited, rather than sharp and strong.[1] This is a "tight oligopoly," dominated by a few large firms, especially Comcast and Time Warner. Their small number commonly leads them to behave like a "shared monopoly," which tends to set high prices and reap high profits at consumers' expense. They are strongly induced to cooperate and avoid rocking the boat, rather than mount price wars.

Not only do such tight oligopolies lean toward higher prices and profits, but they also develop similar price structures, such as the multiple-channel packaging that all of the cable companies apply rigidly (explained in more detail below). Such common patterns prevent any of the firms from becoming innovators and threats to the others in their detailed pricing strategies.

The top cable companies have in fact fit both of these classic patterns of tight oligopoly: their prices have risen steadily and rapidly since the 1970s, and their channel-packaging practices have been rigidly adhered to by all. All this has both applied and reflected the weak competition in the national market. The local-monopoly level of the industry has reinforced the tight oligopoly in the national market, permitting even tighter limits on competition.

**Single-firm dominance.** There's another possible danger to competition: one firm may capture a dominant share of the national market. When one firm gets a market share that is above 30% and a good deal larger than any other, then it may be able to take actions that hurt competition by suppressing the smaller rivals (Hay and Vickers 1987; Scherer and Ross 1990, chapter 10; Shepherd and Shepherd 2004, Chapters 9 and 10). A familiar instance of this is pin-point pricing, which targets specific sub-markets where the dominant firm can drive out rivals, or at least punish and discipline them.[2]

Dominant firms can routinely threaten to do this strategic deep-cut pricing so sharply that the smaller competitors will be stifled and passive because they face high levels of risk. If the laws against "predatory pricing" are applied clumsily and weakly, which they usually are, then dominant firms have a wide range of devices for suppressing their smaller rivals.

All of this makes it crucially important for the FCC to keep its 30% market-share cap on the national cable market. Only narrow theorists and those ignorant of business realities would try to argue that the national market is not important.

The current concentration and dangers to competition make it hard for any company to improve its market position in the national cable TV market, even it if it is highly superior in efficiency and innovation. Such market dominance leaves mergers as an attractive way to grab higher market share. The FCC needs to apply strict anti-merger policies, to prevent the creation of harmful extra market share and market power.

These special conditions in cable TV markets leave only a faint hope that competition might somehow become stronger. And it is only in this national-level market that there is any hope for getting effective competition among cable TV companies. Only that competition could put some constraints on the companies' pricing in their thousands of local monopolies. Equally, this national market is where competition might well be reduced even more, if the FCC were to loosen the 30% standard. In fact, the competition in this national market is already limited and compromised.

**Unique and deviant.** This two-layer market structure is unique in the U.S. economy—uniquely deviant and troubled by market power. No other sector or market has:

- Thousands of local markets that are complete monopolies or nearly so. They range from small to very large.
- Therefore, those local markets are largely unrestrained by market forces or public policies.
- Nearly all of those local markets are already controlled by a handful of big, well-established national firms.

Now, it's true that the national cable TV market is not the only "tight oligopoly" in the economy, highly concentrated in a few hands. A few big sellers do dominate various other national markets, not only in many manufacturing industries but also in retailing, banking, repairs, service markets, and the like. But they don't have thousands of local monopolies under their ownership and control.

**Even in normal markets, a 30% market share gives substantial market power.** In normal markets, as economic research has long shown, the bigger firms begin to have significant effects on the market's pricing as their market shares rise above 20%.[3] By the time they dominate 30% of a market, the effects of market power are usually substantial.[4] These normal markets have ranged across the board, from heavy industry over to the familiar retailing of groceries, books, clothing, hardware, automobiles, etc.

The power of 20-30% market shares is known not only from classic economic research but also from universal business experience. It's worth fighting intensely to raise your market shares to that range. Indeed, struggling your way up through the 20-30% market-share range—or doing an end run with mergers—gives particularly strong increments of profits and market power, for two reasons: not only does the rise in market share give a rich yield in higher profit rates and dollar totals and in control over the market, but it also gives the firm an increasingly prominent presence in the market, as its brands become more famous. That provides momentum to go on upward toward real market dominance of 40%, 50% and 60%.

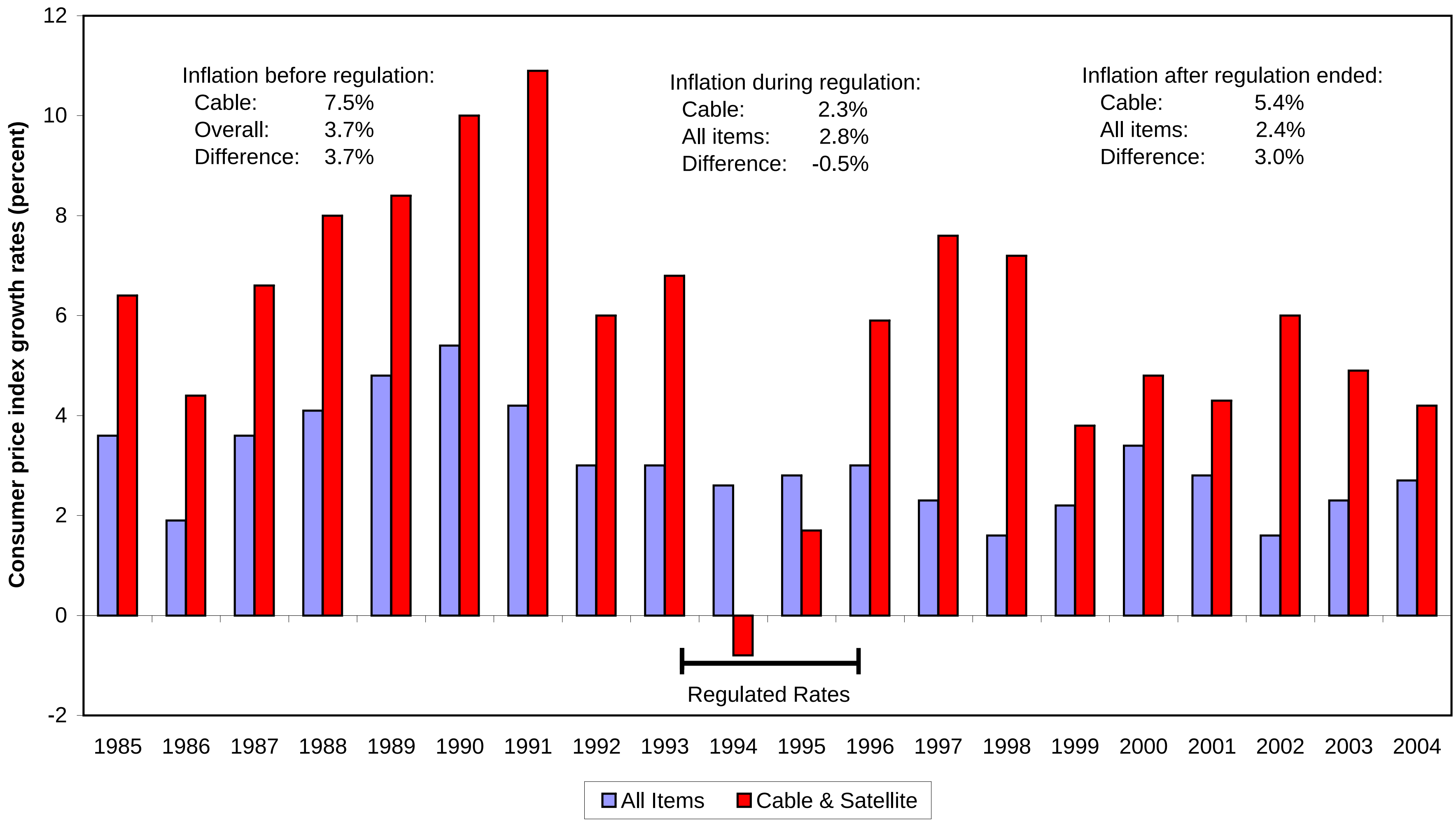
**Market power is accentuated in the national cable TV market.** Cable TV markets are different in ways that make their monopoly power even greater than normal. The standard monopoly effects on profits and market power are intensified by the underlying array of local cable TV monopolies. New competitors can't enter the local cable TV markets, because those local markets are sewn up as monopolies. So the larger regional and national parent firms are strongly protected against new entry and from any strategies by the existing firms to increase their market shares. Competition is contained and reduced. The main way for firms to gain more of the market—often the only way—*is not by competing well with superior efficiency and products, but instead by resorting to mergers among the larger national firms.*

## The Effects of Market Power in Cable TV Markets Have Already Been Large

**The rapid rise in cable TV prices.** These market-power effects have been robust in cable TV markets, as the last 30 years have shown. Between 1985 and 1993, when they had lower national and regional market shares than they now do, the leading cable TV firms have been able to raise their prices almost continuously, and twice as fast as overall consumer prices, on average. That's shown clearly in **Figure 1**. Only when a degree of regulation was briefly applied in 1993-95 was there a pause in the rapid rise of cable prices. Since price regulation ended in 1996, with no new constraints in sight, the cable prices have risen faster, relative to the consumer price index, a trend that is widely expected to continue. Between 1997 and 2004, cable prices increased 125% faster than the overall CPI.

It is also important to note that increased market penetration by direct broadcast satellite (DBS) has not reduced the pricing power of cable TV providers. If anything, the pricing power

**Figure 1: Inflation rates since cable deregulation in 1984: Cable inflation far exeeded overall inflation every year except the two years of regulation**



of cable providers increased in the post-price regulation period despite growth in the number of households receiving DBS.

A recent U.S. General Accounting Office (GAO) study also examined the effect of competition from satellite providers on cable rates. The GAO "did not find that in calendar year 1998 … greater DBS penetration was correlated with lower cable rates. In fact, our model results indicate that greater DBS penetration was correlated with somewhat higher rates" (General Accounting Office 2000, 4). Thus, to date, local cable monopolies aren't being restrained by competition or by potential competition, or by any other factors like consumer demand or new technology such as DBS. These results support findings by others that DBS is not a substitute for cable (Federal Communications Commission 2005, 56-57).

**The strange, rigid structures of cable TV pricing through the packaging of many channels.** There is also an entirely different effect of the monopoly power of the leading cable TV companies, in both the national markets and the local markets. This effect is the companies' *peculiar kind of price structures*, involving the packaging of channels (Flint 2005, A3). Such channel grouping is common in cable TV companies, as every customer knows well. It involves such categories as "basic," "premium," and other varieties.

The multi-channel packaging is also universally recognized to be a strategy that is aimed purely at maximizing the companies' own profits. There is no pretense that instead the packaging might reflect any consumer-demand needs, underlying technical patterns, or efficiencies.

The effects of the channel packaging go directly against most consumers' interests. The proper aim for consumer choice is clear and fundamental in economic analysis. *Choices should be open, free, and flexible,* as they are throughout just about every other market in the economy. Every single distinct product or service in any market should be available to consumers, at a reasonable price. If you want just a chocolate bar, or a pen or other minor item, you should be able to buy it, without having to buy some larger package.

Instead, consumers' choices in cable TV are tightly and rigidly limited, more than necessary and much more than most consumers would freely choose. The system goes directly against consumers' interests. Consumers have to accept and pay for many channels that they don't want. Consumers cannot even negotiate with their cable TV local firm—or with any other firms—to try to get the channels they really want. This extreme violation of consumer freedom of choice is brazen and harmful.

Imagine that the local grocery store offered produce only in rigid packages of 15 tomatoes, five carrots, two cantaloupes, three apples, six potatoes, and one watermelon. If you wanted any, you'd have to take all, take it or leave it. Or suppose that Walmart sold women's clothing only in packages of two dress suits, four skirts, two slacks, six blouses, and three pairs of shoes, and you could not buy any individual amounts of these.

These imaginary packages show how strange, rigid and anti-consumer the very real cable TV packaging is. If there were competition, it would quickly drive the packaging out and force the selling of precisely those individual channels that people want. Instead, the cable TV monopolies can get away with this weird and anti-competitive form of packaging and pricing.

Now, of course some packaging of products is entirely natural and common in other markets, like restaurants, automobiles, and any others where complex products are assembled from various components. But the packaging and pricing are much less extensive in normal markets. Moreover, normally the price patterns are often quite transient, coming and going to reflect consumers' changing interests. The packaging elsewhere is always more flexible than it has been in the cable TV markets. And it's done by firms which are under competitive pressures, with no local monopolies reinforced by large national firms which hold substantial shares of the national market.

Unlike cable TV markets, consumers in other markets almost always have important choices and alternatives. And finally, consumers can negotiate for their best choices with any and all firms. Often they can even reach firms that are located far away, by using the telephone or Internet. The consumers are not locked into the one cable TV company that has their town (and many others) in its monopolistic grip.

In cable TV markets, the anti-consumer structure of many-channel packaging has been the system's chosen pattern for three decades. There are no signs that important changes in it will be tried. No one firm or several firms, either new or old, are offering clear alternatives.

It's a classic instance of monopoly pricing rigidity: it's thorough, it's agreed on by all the major "competitors," it's a major source of excess profits, and it's familiar from the past history of powerful monopolies and dominant firms. Classic historic examples are the old electric monopolies, most drug firms with patented monopoly drugs, United Shoe Machinery during 1900-50, and IBM and Xerox with their near-monopolies in the 1960s.

So both monopoly price *levels* and monopoly price *structures* have been common in U.S. cable TV markets for 30 years. They show no signs of serious voluntary changes nor any unraveling under new competitive pressures. Under the 30% limit, this industry has had major, harmful effects of market power. If market shares are allowed to rise above 30%, these effects of monopoly power will only get larger.

## Are There Innocent or Valuable Reasons for Allowing Cable TV Companies to Gain More Than a 30% Market Share?

The cable firms or their economic advocates may argue that efficiency, technology, or special factors make it helpful to consumers to let the firms breach the 30% constraint. But no such convincing reasons have yet been advanced.

**Leverage?** Larger shares may provide the cable TV companies with more *leverage* or muscle in reaching back to influence the providers of programming content. Indeed, the higher leverage is almost certain to happen if market shares rise over 30%. The leverage could drive down the price of programming. But that effect is not a net economic gain. It simply takes money from one group and gives it to another.

That change will probably put the program providers under pressure to merge so as to resist the new vertical pressures from cable TV companies. That consolidation would be harmful to variety at the programming level.

In fact, that greater concentration at both levels—the national cable TV market and the market for programming content—is a major threat to consumer and social welfare. The rise in vertical leverage is in itself enough reason to keep the 30% limit unchanged, or even reduced. The vertical effects will tend to reduce the variety and quality of programming.

They would also reduce the range of diversity in points of view: in news reporting, commentary, debates, and other activities in the market for ideas. That is among this country's most cherished and fundamental values: freedom and diversity in expression. Higher cable TV market shares would harm variety and healthy debate in all important issues: national policies, political contests, cultural creativity, and all kinds of social issues.

The variety of media sources has been reduced during the last half century, so much so that the danger of further reductions is a major threat to the country's political and social health.[5] That danger is one of the FCC's most important concerns. Proper protection favors a market-share constraint that is not loosened from its existing level of 30%.

**Economies of scale?** Would there perhaps be genuine *economies of scale* for firms as they control ever-larger shares of the market over 30%? Almost certainly not. There is no professionally credible published evidence that genuine economies of scale or coordination in cable TV will occur if market shares go above 10% or 15% in the national cable TV market. A 30% market share is far larger than that. Accordingly, there is no merit in this possible "innocent" or "efficiency-based" argument for relaxing the 30% limit.

**An "infant industry" needing more help?** Is there perhaps some way that cable TV is an "infant industry" that needs help and promoting? On the contrary, the industry is mature and established. Indeed, it is so well established that it can suppress competition pretty thoroughly. It has been highly profitable for a long time, and there is no serious threat to its continued well-being.

## Conclusion

The 30% market share limit has a sound basis in economic research and business reality. As mergers have resulted in cable firms that approach this limit, important monopoly effects have been occurring in the local and national markets. The effects include prices that are too high and continue to rise too fast. They also include rigid and anti-consumer price structures, in the packaging and pricing of channels.

Both the monopoly levels and structures of prices are intensified by the two-level nature of the markets. The local cable TV monopolies accentuate the market-power effects of significant market shares on the national level. They virtually guarantee that there is no effective competition to weaken or remove the already distorting monopoly effects.

Failure to establish a 30% limit would would significantly harm consumers and others outside the market, including the providers of programming content. It would only give more profits and market power to the largest cable TV firms like Comcast and Time Warner.

At the same time, a more lenient rule, or no limit at all, would impose large economic and social harms. There would be higher prices and profits, a further reduction of consumer choices, and more rigid packaging and pricing of TV channels. Also, the diversity and quality of program content would be lowered.

## Endnotes

[1] The classic research source on this is Kaysen and Turner (1959). On the prevalence of collusive tendencies, see the landmark paper by Hay and Kelley (1974, 13-38). See also Martin (1994), Scherer and Ross (1990), Shepherd and Shepherd (2004, chapter 11).

[2] A thorough discussion of this method of attack is in Kahn (1988).

[3] In the typical situation, a rise of 10% in market share (e.g., from 10% to 20%) will raise the profit rate on equity capital by 2% (e.g., from 10% to about 12.5%). This degree of effect occurs throughout the range of market shares. See Eckard (1995, 219-23), Gale and Branch (1982), Ravenscraft (1983), Schmalensee (1985, 341-51), Shepherd and Shepherd (2004, 25-37), and Scherer and Ross (1990, pp 226-230).

[4] The rise to 30% would bring the rate of profit on equity to about 15%, which has been about double the competitive rate of return for fully competitive firms, with small market shares. See (Bradburd, Pugel and Pugh 1991, 432-40, Bresnahan and Reiss 1991, 997-1009, Weiss 1994, Rhoades 1985, 343-63).

[5] For example, Gomery (2002, 1), found that in the newspaper industry "since 1975 the number of media outlets has indeed increased, but at the same time, ownership has become more concentrated, and today there is less diversity of opinion - and less diversity of news sources - than in 1975".

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